

## Rates Spark: Red Hot

More than today's jobs report, markets are increasingly focused on price pressure and its implications on Fed policy. The run up to next week's CPI should see a jump in US rates volatility



### Price indicators suggest a red hot economy

A succession of strong sentiment surveys in the US this week has revived fears of, still distant, Federal Reserve tightening. The only concern is a decline in employment components which, in our economics team's view, heralds another disappointing job growth figure of 500k today. However, the Fed's tone around supply-side constraints in the economy seems to have changed perceptibly as officials prime markets for the tapering announcement that we expect this summer.

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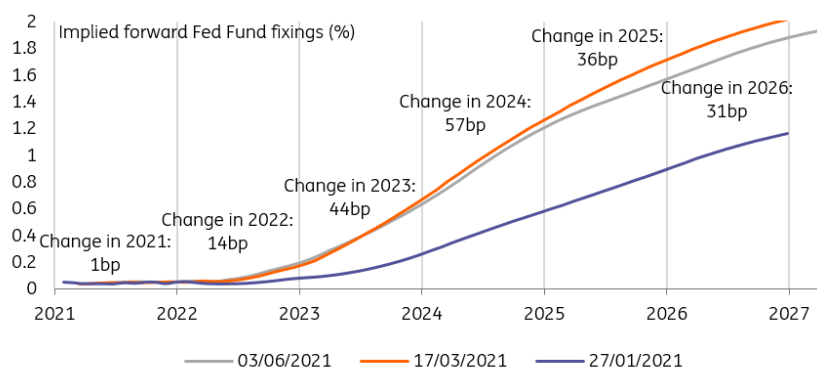
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Increasingly, what the Fed calls 'bottlenecks' are causing price pressure earlier than what would normally be expected at this stage in the recovery. If today's job report comes alongside evidence of higher wage pressure, we think financial markets will be able to ignore the relatively slow pace of job growth and focus instead on the risk of earlier Fed tightening to stamp out inflation.

John Williams of the New York Fed was the latest to add his voice to the chorus of officials saying that easing measures should be discussed. In his typically dovish fashion, he displayed much less urgency than his peers, as he sees the current inflation spike as temporary.

## The Fed Funds curve implies a shallower hiking path than in the previous cycle



Source: Refinitiv, ING

## US swaps are pricing too shallow of a hiking cycle

To be fair, Fed communication around tapering of asset purchases, a prelude to hikes, has been very cautious.

It also helps that virtually the entire market is already expecting a reduction in purchases. Where the surprise could lie is in the speed of the subsequent Fed funds hikes. Currently, the overnight swap curve is implying the policy rate to reach just above 150bp within three years of the first hike in early 2023. We agree with the timing, but not with the ultimate level.

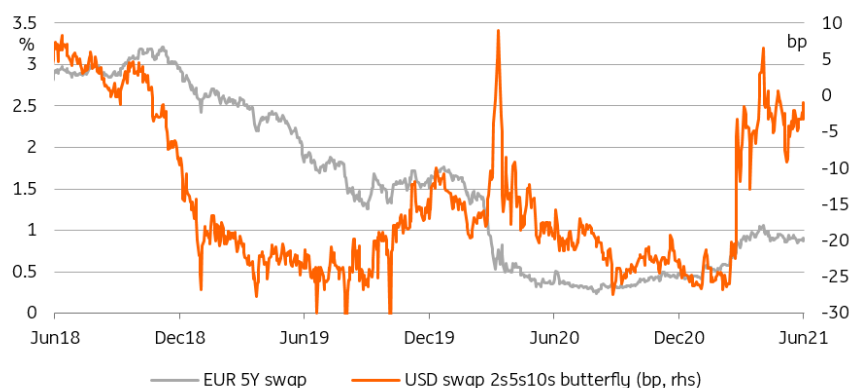
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For comparison, the Fed's first hike in the previous cycle was in late 2015. Within three years, the Fed funds rate approached 250bp. Arguably, the need to rein in inflation is more pressing now than at the start of the previous hiking cycle. There is also the argument that the Fed's tolerance for higher inflation readings under what it calls flexible average inflation targeting imply a later hiking cycle but a steeper one.

## 5Y USD rates will lead the charge higher if tightening fears rise



Source: Refinitiv, ING

This makes the part of the US yield curve most sensitive to the speed of Fed tightening - a dangerous place to be in our view. Rates in the 5-7 year sector rose faster than their peers yesterday, echoing moves seen in the first quarter of this year when tightening concerns first came to the fore. We would argue that into next week's CPI report, expected to approach 5% year-on-year, the sector will be under renewed pressure.

### Today's events and market view

In addition to the US jobs report, the main event today will be the release of factory orders and durable goods orders. The latter will be a second release, so less liable to surprise the market. Strong sentiment indicators earlier this week and the looming CPI reading next week have the potential to shake complacent carry trades out, especially in the belly of the curve. We expect higher USD rates led by the 5-7Y sector as volatility increases after almost three months of relative calm.

There is very little on the calendar by way of EUR-centric events. We expect EUR rates to happily follow their US peers higher today, but to prove more resilient as the proximity of the ECB meeting deters large new positioning.

A survey of economists published by Bloomberg roughly matches our view. Almost 80% expect the current rate of PEPP purchases to be extended for another quarter. Besides the difficulties in carrying them out in illiquid summer markets, we think it will be a tricky message to deliver at the same time as better economic and inflation forecasts. The breadth of the consensus and the risk of mixed messaging lead us to think that EUR rates will resume their climb after the meeting.

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